

## Securities Finance Market Monitor

Issue 29, for the Month Ending September 30, 2004

### Money Markets Recap

#### Fed raises rates in September as oil prices rise

The yield curve flattened significantly in September, with the 2 and 10-year note spreads moving from 182 basis points to 161 basis points at month end. Some market participants were certainly caught by surprise as the yield on the 10 year UST note dipped below 4.00% following the FOMC meeting on September 21st, at which the Federal Funds target rate was increased by another 25 basis points to a new level of 1.75%. This was the third 25 basis point increase in as many meetings, and on the basis of the statement that followed their action, it appears as though there will be at least one more 25 basis point increase this year. The rally in the longer end of the market was especially puzzling given the upward movement in energy prices. Crude oil approached \$50 per barrel, and it did not appear as though the \$50 level was going to offer much resistance. Several economists have begun to reduce their forecasts for the pace of economic growth as a result of the rising cost of oil and related products. One other note of interest was the report late in the month by the Office of Federal Housing Enterprise Oversight, which regulates Fannie Mae and Freddie Mac, in which the regulator accused Fannie Mae of non-conforming accounting practices and manipulation of earnings in order to meet executive compensation triggers. Strangely enough, the ensuing backup in Fannie Mae paper was not as severe as what had occurred last year when less serious accusations were levelled against Freddie Mac. At that time, we saw Freddie Mac discount notes trade to commercial paper levels and purchased a significant amount of discount notes in the cash collateral portfolios. That has not been the case with Fannie Mae, as discount notes continue to trade 6 to 10 basis points behind CP.

We will continue to monitor the story and events and evaluate any opportunities to purchase Agency discount notes for the securities lending cash collateral portfolios.

### US Government Markets Commentary

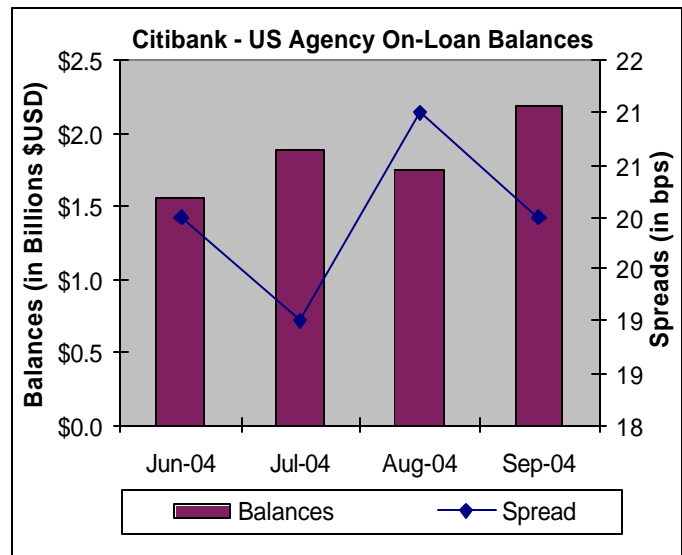
#### US Agency securities see increased demand

Federal funds futures show traders are pricing in almost a 40 percent chance the central bank will lift the benchmark rate to 2.25 percent by year-end. The December contract yields 2.04 percent, in September. The yield is the expected average fed funds rate for a particular month.

Treasuries prices turned lower in mid-September as speculators sold short-term notes while a report on U.S. business investment contained enough soft spots to support longer-dated debt. This was evident in the lending portfolios as on-loan balances for shorter maturities were in strong demand throughout September. In addition, the

current 5-year note 912828CV0 and the current 2year note 912828CU2 both traded at least 50 bps below Fed Funds.

US Agencies have seen increased demand over the past four months (please refer to the chart below). This increase in demand is a function of continuing concerns about the implied backing of the US Government and accounting irregularities at Fannie Mae. Lending spreads have fluctuated in a narrow band between 18-21 basis points.



### US Equity/Bond Markets Commentary

#### Global equity markets show some signs of life

The equity markets showed some signs of life in September, as the NASDAQ rose 3.2% and the S&P had two months of small but positive returns. The FTSE 100 index increased 2.5%. While these returns are modest at best, there was some good news behind the numbers. Bank stocks were punished for continuing scandals such as Parmalat. Also, Fannie Mae -a large S&P 500 stock-dropped as much as 15% during the month.

In the lending markets one stock, which we have seen as a specials stock for some time, is Krispy Kreme. This security was special for most of 2002 and 2003 even as its stock priced continued to climb to nearly \$50 per share all-time highs. Recently in 2004, accounting irregularities and poor earnings performance has battered the stock to just over \$10 per share. This represents an example of how securities finance may help to identify securities that hold intrinsic values that deviate from the indicators traditionally used to determine a securities long-term directional movement.

## Specials Lending Activity

### US Bond/Equity

**Delta Airline (DAL)** – shares dropped as oil hit a new high of \$53 (10/7/04). Analysts predict a high probability that Delta could file for bankruptcy in the near future. Industry experts find that the airline could avoid bankruptcy by making concessions with its pilots. Among firms in the airline industry, Delta's pilots are not only the highest paid, but also unionized.

**Pfizer (PFE)** – shares fell on the expectations that a federal judge will refuse a motion to block a generic version of Neurontin, a \$3 billion epilepsy drug. Pfizer has sought an injunction from a federal court to prevent AlphaPharma and its partner Teva Pharmaceutical Industries from selling a generic version of Neurontin.

**Corning (GLW)** – shares suffered after it announced that it would take an estimated \$2.8 to \$2.9 billion charge due to its in its telecommunications business. The New-York based company announced that \$1.4 billion of the write-down relates to goodwill. Another \$1 billion relates to accounting changes, and \$420 million is related to its operations in Concord, North Carolina.

### Non-US Bond/Equity

#### Norway

**Storebrand (4852832)** has announced that it will buy back 1.138 million shares at NOK \$50.26 each. Brokers have sought to reserve lending positions in the stock in anticipation of an arbitrage opportunity.

#### Denmark

**TDC (5698790)** has offered to purchase **Song Networks (7449145)** in a stock and cash deal. TDC is currently trading at in a range of 5-50 basis points. Song Networks stock offered at 0% rebate.

#### Australia

**6710347 QAN AU** - Stock suspended from trading throughout the day as BA announced they will sell its stake in Qantas Airways. Brokers are looking to hold for the time being.

## FYI – Repurchase Agreements

Repurchase Agreements, called Repos, are money market transactions in which one party sells securities to another while agreeing to repurchase those same securities at a specific price on a specific forward date. These transactions are similar to secured loans, with the lender of money receiving securities as collateral to protect it against borrower default. Repos are viewed by some market participants as purchases and sales and by others as secured loans. Parties lending money are referred to as "buyers," while parties lending securities are

© 2004 Citibank, N.A. All rights reserved. CITIBANK, CITIGROUP and the Umbrella Device are trademarks and service marks of Citicorp or its affiliates and are used and registered throughout the world. Sources: Moody's Investors Services, Forbes, Scudder Mutual Funds, Reuters and Bloomberg. For additional information please contact: thad.garrison@citigroup.com.

*This newsletter is provided by Citibank solely as a service to its clients. The information contained herein is for informational purposes only. The information contained herein does not constitute a recommendation by Citibank to take any action, and Citibank is not providing any investment, tax or legal advice to any client. Under no circumstances is the information contained herein to be considered or used as an offer to sell, or a solicitation of any offer to buy, any security.*

referred to as "sellers." The terms "securities" and "collateral" are generally interchangeable. These distinctions become clear later when we analyze the hybrid nature of Repos.

The terms "Repurchase Agreement," "Repo," "RP," "Reverse Repo" and "Resale" are all used to describe the same transaction. One firm's Repo is another firm's Reverse Repo; both are the same transaction viewed from two different perspectives. It is common Street practice for both parties to view the transaction from the dealer's perspective. A dealer borrowing money is executing a Repo, while a dealer borrowing securities is executing a Reverse Repo. Accordingly, when a client lends money to a dealer, the transaction is called a Repo by both parties.

Delivery refers to the possession and control of securities "delivered" under a repurchase agreement. There are two delivery alternatives for Repo collateral: (1) receiving securities in an independent custodial account or (2) receiving securities in a segregation account with the dealer counterparty's account.

**Deliverable Repo.** The investor receives possession of securities in some manner. Possession of the securities creates a "perfected lien," or valid ownership (on the collateral). The cash investor receives the rights of ownership. There are two forms of delivery: "delivery versus payment" and "tri-party delivery." Tri-Party Repo has become the most popular form of delivery.

**Tri-party Deliverable Repos.** A dealer, cash lender and third party custodian bank enter into a tri-party agreement in which the custodian bank acts as the intermediary in the Repo transaction and holds the collateral on behalf of the buyer.

**Segregation Repo.** The cash lender receives a pledge of acceptable securities which are segregated within the dealer's own clearing account. It is also commonly referred to as Hold-in-Custody, Safekeeping, and Mixed Bag Repo.

Repos are executed for maturities of between one day and five years (occasionally longer under special circumstances), with most having maturities of one year or less. Many are executed on an overnight (one day) basis. Transactions involving international securities are often executed for periods of one week or longer.

## Citibank Securities Finance Contacts:

Alejandro Berney	US	1-212-657-1075
Thad Garrison	US	1-212-657-4032
Victoria Bright	UK	44-207-500-5467
Paul O'Brien	SG	65 6328-5350
Tony Evans	US	1-212-657-9522

**[www.transactionservices.citigroup.com](http://www.transactionservices.citigroup.com)**